Transfer Pricing in Pakistan

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Briefing on the Transfer Pricing ("TP") Regulations

From an overall historical perspective, TP regulations in terms of dealing with transactions in accordance with the arm's length principle were in place since the time of partition when the Income Tax Act, 1922 was adopted by the Government of Pakistan and had been evolving to a greater extent from the past few years. Pakistan became a member of OECD Convention in September 2016 by signing Multilateral Convention on Mutual Administrative Assistance in Tax Matters.

By virtue of Article 6 of the OECD Convention, two Multilateral Competent Authority Agreements (MCAA) in regard to automatic exchange of tax information protocols, signed on June 7, 2017, whereas the other one, the Multilateral Competent Authorities Agreement is related to the exchange of Country-by-Country reports (CbC MCAA), signed on June 21, 2017 and subsequently the government issued S.R.O. 1191(1)/2017 dated November 16, 2017 to regularize TP through documentation and Country-by-Country Reporting (CbCR) requirements.

Income Tax Ordinance, 2001 provides that where business transactions between a resident and a non-resident person are not on arm's length basis and such transactions result in shifting of business profits to the non-resident, the tax authorities are empowered to re-compute the profits such that these reflect the actual profits to tax them accordingly.

Transactions between associates need to be reported at arm's length standard to reflect the income that a person would have realized based on its fair value. The revenue authorities in Pakistan are fully empowered to distribute, apportion or allocate the income, deductions or tax credits among the associates to reflect a transaction at fair value if an arm's length principle is not followed.

In determining the arm's length price 'Comparable Uncontrolled Price Method' is generally followed in Pakistan. Income Tax Rules, 2002 prescribe the parameters for the determination of an arm's length price. The revenue authorities may use any of the following methods to determine an arm's length result, namely:

a) Comparable Uncontrolled Price method i.e. the comparison with prices charged in comparable transactions between independent parties;
b) Resale Price Method i.e. the subtraction of a margin from the end-selling price to an independent third party;
c) Cost Plus Method i.e. the addition of a margin to the costs of producing the relevant goods or services, etc.; or
d) Profit Split Method i.e. Transactional Profit Methods.

Documentation Requirements

Every person engaging in a transaction with their associate(s) is required to keep and maintain the following records:

- Master file containing documents and standardized information relevant for all MNE group members;
- Local file for all transactions, exceeding fifty million Rupees, with the associates;
- Keep, maintain and furnish to the Federal Board of Revenue (the Board) prescribed CbCR, where applicable;
- Keep and maintain any other information and document in respect of transaction with its associate as may be prescribed; and
- Keep the files, documents, information and reports specified above for the period as may be prescribed.

An entity that has entered into a transaction with its associate shall furnish to the revenue authorities within 30 days, maximum extension of 45 days, the documents and information to be kept and maintained as mentioned above.

Country-by-Country Reporting (CbCR) Requirements

'MNE group' means any group having two or more entities in different tax jurisdictions with a total consolidated group revenue equivalent to seven hundred and fifty million euros or more, or an equivalent amount in Pakistan Rupees. The CbCR encompassing detailed financial and tax information relating to the global allocation of the income and taxes shall be filed by an Ultimate Parent Company, Surrogate Parent Company or constituent entity of an MNE group resident in Pakistan not later than twelve months after the last day of the reporting fiscal year of the MNE group.

The CbCR shall be used appropriately meaning thereby:

- conducting high level and informed transfer pricing risk assessment;
- assessment of other base erosion and profit shifting (BEPS) related risks;
- economic and statistical analysis, where appropriate.

Disclosure in Annual Tax Filing

The following disclosures have been made mandatory in the annual income tax compliance:

Do you have any transactions with Non-Resident associates (exceeding PKR 50 Millions)? Yes / No

Transactions greater than PKR 50 Million with Non-Residents associates

Description	*Receipts*	*Payments*
Total Value of Revenue Transactions with Non-Resident associates		
Total Value of Capital Transactions with Non-Resident associates		

Controlled Foreign Company - CFC Reporting Requirements

Under the global tax regime concept, tax has been imposed on income derived from a non-resident company, to be termed as a CFC, even prior to the distribution of dividends, in case the offshore entity is owned by a Pakistani resident person.

Under the common control and management, a CFC is ascertained on the following parameters:

- More than 50% of the capital or voting rights are held by one or more persons or 40% by a single person;
- Tax paid in respect of income derived or accrued in a foreign tax year is less than 60% of tax payable in Pakistan; and
- The company does not derive active business income.

Thin Capitalization

Where a foreign-controlled resident company (FCRC) has a foreign debt-to-foreign equity ratio in excess of three to one at any time during a tax year, a deduction shall be disallowed for the profit on debt paid by the company in that year on that part of the debt which exceeds the three to one ratio. Any profit on foreign debt incurred by Foreign Controlled Resident Company in excess of 3:1 foreign debts to foreign equity ratio at any time during the year shall not be allowed as tax expense.

However, only such debt will be considered part of the foreign debt if the profit on such debt is paid in either of the following manner:

- Profit on debt is paid without deduction of tax; or taxed at a rate lower than the corporate rate applicable on assessment of foreign controller or its associates.

Latest Updates in Tax Laws

As per the applicable laws in Pakistan, a Directorate General of International Tax Operations has been set up and assigned the responsibility for:

- receive and send information from other jurisdictions;
- levy and recover tax by passing an assessment order in case of undeclared off-shore assets and incomes;
- receive, transmit and exchange country reports to the jurisdictions that are parties to international country-by-country agreements with Pakistan; and
- conduct transfer pricing audit in cases selected for such audit by the Director General of International Tax Operations.

This has been clarified that transfer pricing audit refers to the audit for determination of transfer price at arm's length in transactions between associates and is independent of any comprehensive tax audit proceedings initiated under Section 177 and 214C which is an audit of the income tax affairs of the taxpayer.

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